26 Tax Withholdings

Withholding taxes give the Government part of your income before you have a chance to use it. Withholding tax is imposed on salary and wage income, tip income, certain gambling winnings, pensions, and retirement distributions, but you may avoid withholding on retirement payments; *see* ¶26.11. Withholding is also imposed on interest and dividends if you do not give your taxpayer identification number to a payer of interest or dividend income.

You may increase or decrease withholdings on your wages by submitting a new Form W-4 to your employer. Withholdings may be reduced by claiming allowances based on tax deductions and credits.

Make sure that tax withholdings meet or help you meet the estimated tax rules that require withholdings plus estimated tax payments to equal 90% of your current year liability or the required percentage of the prior year's liability; *see* Chapter 27.

A 20% withholding rate applies to nonperiodic distributions from an employer retirement plan. You may avoid the withholding by instructing your employer to directly transfer the funds to an IRA or the plan of your new employer; see ¶26.11.

¶26.1 Withholdings Should Cover Estimated Tax

In fixing the rate of withholding on your wages, pay attention to the tests for determining whether sufficient taxes have been withheld from your pay. A penalty will apply if your wage withholdings plus estimated tax payments do not equal the lesser of 90% of your current tax liability and the required percentage of the prior year's tax; *see* ¶27.1.

Taxes are withheld from payments made to you for services that you perform as an employee; *see* ¶26.2 for exceptions. By filing Form W-4, you claim exemptions for yourself, your spouse, and dependents. The number of exemptions claimed will either decrease or increase the amount of withholding. You also may claim withholding allowances for itemized deductions and credits such as the credit for the elderly and totally disabled, the foreign tax credit, credit for home mortgages, the general business credit, and earned income credit (if you have not filed for an advance payment of the credit on Form W-5).

¶26.2 When Income Taxes Are Withheld on Wages

The amount of income tax withheld for your wage bracket depends on your marital status and the number of exemptions you claim. Exemptions for withholding correspond to the exemptions allowed on your tax return; *see* ¶22.1. You file a withholding certificate, Form W-4, with your employer, indicating your status and exemptions. Without the certificate, your employer must withhold tax as if you are a single person with no exemptions.

If you do not expect withholdings to meet your final tax liability, ask your employer to withhold a greater amount of tax; *see* ¶26.3. On the other hand, if the withholding rate applied to your wages results in overwithholding, you may claim extra withholding allowances to reduce withholding during the year; *see* ¶26.5 and ¶26.6.

Cash payments or the cash value of benefits paid to an employee by an employer are subject to withholding, unless the payments are specifically excluded.

INCOME TAXES ARE WITHHELD ON:

- Payments to employees as salaries, wages, fees, commissions, pensions, retirement pay, vacation allowances, dismissal pay, etc. (whether paid in cash or goods). The withholding rate on separately paid bonuses is 28%. *See* ¶26.11 for withholding on pensions and annuities.
- Sick pay paid by your employer. If a third party pays you sick pay on a plan funded by your employer, you may request withholding by filing Form W-4S.
- Taxable group insurance coverage for amount over $50,000.
- Reimbursements of expenses that do not meet qualifying rules of accountable plans discussed at ¶20.31. Also, reimbursements from accountable plans that exceed federal rates if the employee does not return the reimbursement or show that it is substantiated by proof of expenses.
- Pay to members of the U.S. Armed Forces.
- Prize awarded to a salesman in a contest run by his employer.
- Retroactive pay and overtime under Fair Labor Standards Act.
- Taxable supplemental unemployment compensation benefits.
- Back pay under National Labor Relations Board order and settlements under the Civil Rights Act of 1964 for job applicants refused employment on discriminatory grounds; but *see* ¶12.10.
- Payments to Canadians and Mexicans who cross borders frequently and who are not working in transportation service.

INCOME TAXES ARE NOT WITHHELD ON:

- Payments to household workers. However, although income tax withholding is not required, the worker and the employer may make a voluntary withholding agreement; *see* ¶25.7.
- Payments to agricultural workers, college domestics, ministers of the gospel (except chaplains in the Armed Forces), casual workers, nonresident aliens, public officials who receive fees directly from the public, notaries, jurors, witnesses, precinct workers, etc.; but *see* voluntary withholding agreements, ¶26.3.
- Pay for newspaper home delivery by children under age 18.
- Advances for traveling expenses if the employee substantiates expenses to the employer and if the employee returns any unsubstantiated amount; *see* ¶20.31.
- Value of tax-free board and lodging furnished by an employer.
- Fringe benefits not subject to tax.
- Substantiated reimbursements for deductible moving expenses or medical care benefits under a self-insured medical reimbursement plan.
- Death benefit payments to beneficiary of employee; wages due but unpaid at employee's death and paid to estate or beneficiary.
- Pay for U.S. citizen working abroad or in U.S. possessions to the extent that the pay is tax free; *see* Chapter 36 for rules.
- Lump-sum settlement from employer for cancellation of employment contract.
- Employer contributions to SEPs; *see* ¶8.16.
- Earnings of self-employed persons, as they pay their income taxes currently through estimated tax.

Form W-2. By the end of January, your employer must give you duplicate copies of Form W-2, which is a record of your pay and the withheld income and Social Security taxes. If you leave your job during the year, you may ask your employer for a Form W-2 by making a written request within 30 days of leaving the job.

¶26.3 Increasing Withholding

For withholding tax purposes, you do not have to claim all your exemptions. This will increase the amount withheld and help reduce the final tax payment on filing your tax return. It may also relieve you of having to make quarterly estimated tax payments, provided

the withholdings are sufficient to meet your estimated tax liability; *see* ¶27.1. A waiver of exemptions for withholding taxes does not prevent you from claiming the "waived" exemptions on your final tax return. The waiver is merely a bookkeeping aid to your company's payroll department. If you find that even a waiver of exemptions does not cover all of the tax you want withheld, you may ask your employer on Form W-4 to withhold additional amounts from each paycheck.

¶26.4 Avoiding Withholding

If you had no income tax liability in 1996 and expect none for 1997, you may be exempt from income tax withholdings on your 1997 wages. If eligible, students working for the summer, retired persons, and other part-time workers do not have to wait for a refund of withheld taxes they do not owe. The exemption applies only to income tax withholding, not to withholdings for Social Security and Medicare (¶26.10).

However, if you can be claimed as a dependent on another person's tax return, and you have any investment income, you may claim this special exemption only if you expect total income (wages plus investments) to be no more than the minimum standard deduction for dependents, which in 1996 was $650 (¶13.5). If the $650 amount is increased due to an inflation factor, the higher amount will be on the 1997 version of Form W-4.

If you cannot be claimed as a dependent by another person, you can claim the exemption from withholding if your total income is no more than the sum of your personal exemption and the standard deduction for your filing status.

To claim an exemption for 1997, you must file a withholding exemption certificate, Form W-4, with your employer. The form may be obtained from an IRS district office or from your employer. If you will file a joint return for 1997, do not claim an exemption on Form W-4 if the joint return will show a tax. An exemption claimed during 1997 will expire February 17, 1998.

¶26.5 Withholding Allowances

Too much may be withheld from your pay if you have tax reduction items. The overpayment will be refunded when you file your return, but you lose the use of your money during the year. By filing Form W-4 with your employer, you may avoid this and reduce withholding taxes by claiming additional withholding allowances based on the following: (1) estimated itemized deductions; (2) IRA contribution deductions; (3) alimony deductions; (4) net losses from Schedule C, D, E, or F of Form 1040; and (5) tax credits such as the dependent care credit, credit for the elderly, earned-income credit (if you did not request advance payment on Form W-5), and general business credit.

Working couples filing jointly figure withholding allowances on their combined wage income, deductions, adjustments, and credits, but can divide the total number of allowances between them in any way they wish. On separate returns, the allowances must be figured separately.

If you work for two or more employers at the same time, you figure your allowances based on the total income, and then split the allowances between the two jobs in any way you wish. Do not claim the same allowances with more than one employer at the same time.

File a new Form W-4 each year for withholding allowances based on itemized deductions and credits. Furthermore, you may have to file a new form to increase your withholding if withholding allowances you had been claiming are no longer allowed; *see* ¶26.7.

A civil penalty of $500 may be imposed if, for purposes of claiming tax withholding allowances, you overstate your itemized deductions and credits or understate your wages without a reasonable basis. There is also a criminal penalty of up to $1,000 plus a jail sentence for willfully supplying false information.

¶26.6 Special Withholding Allowance

A special withholding allowance designed to eliminate overwithholding may be claimed on Form W-4 by certain employees. The withholding allowance, like an exemption, frees wage income from withholding. An unmarried person may claim this special withholding allowance, provided he or she is not working for more than one employer. If you are married, you may claim the allowance if you work for only one employer and your spouse does not work, or your wages from a second job or your spouse's wages are $1,000 or less. This special allowance is only for withholding purposes. You may not claim it on your tax return.

¶26.7 When To File New Form W-4

You should file a new Form W-4 any time the number of your exemptions or withholding allowances increases or decreases, such as when a child is born or adopted, you marry, you get a divorce, or your deductible expenses change.

Your employer may make the new Form W-4 effective with the next payment of wages. However, an employer may postpone the new withholding rate until the start of the first payroll period ending on or after the 30th day from the day you submit the revised form.

You must file a new Form W-4 within 10 days if the number of allowances previously claimed by you decreases because: you divorce or legally separate; you stop supporting a dependent; or a dependent for whom you claimed a withholding allowance will receive more than the exemption amount for the year ($2,550 in 1996), but this income restriction does not apply to your child who is under 19 years of age or a student under age 24 as of the end of the year.

The death of a spouse or a dependent in a current year does not affect your withholding until the next year but requires the filing of a new certificate, if possible, by the first business day in December, or

within 10 days if the death is in December. However, a widow or widower entitled to joint return rates in the next two years as a qualifying widow or widower with a dependent child (¶1.6) need not file a new withholding certificate.

When you file on or before December 1, your employer must reduce your withholding as of January 1 of the next year.

¶26.8 When Tips Are Subject to Withholding

Tips are subject to income tax and FICA (Social Security and Medicare) withholdings. If you receive cash tips amounting to $20 or more in a month, you must report the total amount of tips received during the month to your employer on Form 4070 (or a similar written report). You make the report on or before the 10th day after the end of the month in which the tips are received. (If the 10th day is a Saturday, Sunday, or legal holiday, you must submit the report by the next business day.) For example, tips amounting to $20 or more that are received during January 1997 are reported by February 12, 1997. Your employer may require more frequent reporting.

You include cash tips paid to you in your own behalf. If you "split" or share tips with others, you include in your report only your share. You do not include tips received in the form of merchandise or your share of service charges turned over to you by your employer.

You are considered to have income from tips when you make your report to your employer. However, if you do not report your tips to your employer, you are considered to have tip income when you receive the tips. For example, if you received tips of $200 during December 1996 and reported the tips to your employer on January 8, 1997, the tips are considered paid to you in January 1997, and the $200 is included on your 1997 income tax return. On the other hand, if your tips during December 1996 totaled only $18, you are not required to report the amount to your employer. The tips are considered paid to you in 1996 and must be included in your 1996 income tax return.

Your employer withholds the Social Security, Medicare, and income tax due on the tips from your wages or from funds you give him or her for withholding purposes. If the taxes due cannot be collected on the tips, either from your wages or from voluntary contributions, by the 10th day after the end of the month in which tips are reported, you have to pay the tax when you file your income tax return.

Where wages are insufficient to meet all of the withholding liability, the wages are applied first to Social Security and Medicare tax.

If your employer is unable to collect enough money from your wages during the year to cover the Social Security or Medicare tax on the tips you reported, the uncollected amount is shown on your Form W-2 in Box 13 with Code A next to it for Social Security or Code B for Medicare. You must report the uncollected amount on Line 51 of Form 1040 as an additional tax due; write "Uncollected Tax on Tips" and show the amount next to Line 51.

If you have not reported tips of $20 or more in any month, or tips are allocated to you under the special tip allocation rules discussed below, you must compute Social Security and Medicare tax on that amount on Form 4137 and enter it as a tax due on Line 47 of Form 1040; attach Form 4137 to Form 1040. The unreported tips must be included as wages on Line 7 of Form 1040.

Penalty for failure to report tips. Failure to report tip income of $20 or more received during the month to your employer may subject you to a penalty of 50% of the Social Security and Medicare tax due on the unreported tips, unless your failure was due to reasonable cause rather than to willful neglect.

Tips of less than $20 per month are taxable but not subject to withholding.

Tip allocation reporting by large restaurants. To help the IRS audit the reporting of tip income, restaurants employing at least 10 people must make a special report of income and allocate tips based on gross receipts. For purposes of the allocation, the law assumes tip income of at least 8%. If you voluntarily report tips equal to your allocable share of 8% of the restaurant's gross receipts, no allocation will be made to you. However, if the total tips reported by all employees is less than 8% of gross receipts and you do not report your share of the 8%, your employer must make an allocation based on the difference between the amount you reported and your share of the 8% amount. The allocated amount is shown on Form W-2. However, taxes are not withheld on the allocated amount. Taxes are withheld only on amounts actually reported by employees. An employer or majority of employees may ask the IRS to apply a tip percentage of less than 8%, but no lower than 2%.

Reporting allocated tips. Your employer will show allocated tips in Box 8 of your Form W-2. However, this amount will not be included in Box 1 wages and you must add it to income yourself by reporting it on Line 7 of Form 1040. You also must compute Social Security and Medicare tax on the allocated tips on Form 4137 and enter the tax from Form 4137 on Line 47 of Form 1040. You may not use Form 1040A or Form 1040EZ.

¶26.9 Withholding on Gambling Winnings

Gambling winnings are generally reported on Form W-2G if the amount paid is $600 or more and at least 300 times the amount of the wager; the payer has the option of taking into account the wager in applying the $600 test. Different reporting rules apply to winnings from keno, bingo, and slot machines. Keno winnings are reported on Form W-2G if they are $1,500 or more, *reduced* by the wager. Winnings from bingo or slot machines of $1,200 or more, *not* reduced by the wager, are reported on Form W-2G.

Your winnings from gambling may be subject to 28% withholding. Withholding applies if your winnings exceed:

1. $5,000 from lotteries, sweepstakes, and wagering pools (whether or not state-conducted) including church raffles, pari-mutuel betting pools and on- and off-track racing pools; and
2. $5,000 from other wagering transactions, if the proceeds are at least 300 times as large as the amount wagered, such as from wagers on horse races, dog races, or jai alai.

If your winnings exceed the $5,000 threshold the withholding rate applies to your gross winnings less your wagers, and not just the amounts over $5,000. Any withholdings will be shown on Form W-2G.

Winnings from bingo, keno, and slot machines are not subject to 28% income tax withholding. However, if you do not provide a taxpayer identification number, the payer will withhold tax at the 31% backup withholding rate (¶26.12).

The IRS requires you to tell the payers of gambling winnings if you are also receiving winnings from identical wagers; winnings from identical wagers must be added together to determine if withholding is required.

If you have agreed to share your winnings with another person, give the payer a Form 5754. The payer will then prepare separate Forms W-2G for each of you.

¶26.10 FICA Withholdings

FICA withholdings are employee contributions for Social Security and Medicare coverage. Your employer is liable for the tax if he or she fails to make proper withholdings. The amount withheld is figured on your wages and is not affected by your marital status, number of exemptions, or the fact that you may be over age 65 and are collecting Social Security. On Form W-2, Social Security withholdings are shown in Box 4 and Medicare withholdings in Box 6.

Subject to FICA tax are your regular salary, commissions, bonuses, vacation pay, cash tips, group-term insurance coverage over $50,000, the first six months of sick pay, and contributions to cash or deferred (401(k)) pay plans or salary-reduction contributions to a simplified employee pension (SEP) or tax-sheltered annuity. Not subject to tax are the value of tax-free meals and lodgings under ¶3.11 and reimbursements for substantiated travel or entertainment expenses or for moving expenses.

Excess Social Security and Railroad Retirement withholding. If you have worked for more than one employer during 1996, attach all Copies B of Form W-2 to your return. Check to see that the total withheld in 1996 by your employers does not exceed your liability for FICA taxes. For Social Security, the maximum 1996 liability is $3,887.40, 6.2% on the first $62,700 of salary income. If too much was withheld, claim the excess as a payment on Line 56 of your 1996 Form 1040. On Form 1040A, the excess is added to your total tax payments; you cannot claim the excess on Form 1040-EZ.

Medicare tax is withheld at a rate of 1.45% on *all* salary and wage income.

Employees covered by the Railroad Retirement Tax Act (RRTA) receive Form W-2, which lists total wages paid and withholdings of income and Railroad Retirement taxes. Follow tax form instructions for claiming a credit for excess Railroad Retirement withholding.

If any one employer withheld too much Social Security or Railroad Retirement tax, you cannot claim the excess on your income tax return. You must ask that employer for a refund of the excess.

Wages you pay to your spouse or child. Wages you pay to your spouse for working in your business are subject to FICA tax and income tax withholding. Wages you pay to your child for working in your business are subject to income tax withholding but exempt from FICA if the child is under age 18. Wages you pay to your child under age 21 or to your spouse for domestic work or child care in your own home are exempt from FICA.

Wages paid to household employees. *See* ¶25.8 for FICA withholding on wages paid to household employees.

¶26.11 Withholding on Retirement Distributions

Retirement distributions are subject to withholding taxes, but you may avoid withholdings. The method of avoiding withholding varies with the type of payment.

Periodic payments. If you receive periodic payments, such as an annuity, withholding is required unless you elect to avoid withholding on Form W-4P, or on a substitute form furnished by the payer. If you are a U.S. citizen or resident alien, withholding may not be avoided on pensions or other distributions paid outside the U.S. or U.S. possessions. Payment must be to your home address within the U.S. (or in a U.S. possession) to avoid withholding.

Unless you tell the payer otherwise, wage withholding tables are used to figure withholdings on periodic payments as if you were married and claiming three withholding exemptions. Withholding allowances may be claimed on Form W-4P for estimated itemized deductions, alimony payments, and deductible IRA contributions.

You may also request that the payer withhold a specific amount of additional tax for each payment.

Nonperiodic payments from IRAs and commercial annuities. Nonperiodic payments are subject to withholding at a flat 10% rate unless you elect to avoid withholding on Form W-4P (or substitute form). IRA distributions that are payable upon demand are considered nonperiodic and, thus, subject to the 10% withholding rule.

Nonperiodic payments from qualified employer plans. Employers must withhold 20% from nonperiodic payments, such as lump-sum distributions that are eligible for tax-free rollover but which are

paid directly to you. To avoid withholding you must tell your employer to make a direct rollover (¶7.8) of the funds to an IRA or to a defined contribution plan (¶8.4) of your new employer. If you do not instruct your employer to make the direct transfer and elect to personally receive the distribution, 20% will be withheld before payment is made to you.

See ¶7.8 for a further explanation and an Example showing the effects of the withholding rule where you receive the distribution and then decide to make a rollover yourself.

LAW ALERT

Voluntary Withholding on Social Security

Starting in 1997, you may choose to have income tax withheld from your Social Security checks. You also may choose a withholding rate of either 7%, 15%, 28%, or 31%.

You may want to elect withholding to avoid making estimated tax installment payments. The Social Security Administration has a form for making the withholding election.

¶26.12 Backup Withholding

Backup withholding is designed to pressure taxpayers to report interest and dividend income. You may be subject to backup withholding if you do not give your taxpayer identification number to parties paying you interest or dividend income, you give an incorrect number, or you ignore IRS notices stating that you have underreported interest or dividends. Your taxpayer identification number is your Social Security number or your employer identification number. The backup withholding rate is 31%.

Similarly, backup withholding of 31% can apply to fees of $600 or more (Form 1099-MISC) for work you do as an independent contractor, payments from brokers (Form 1099-B), royalty payments (Form 1099-MISC) and certain gambling winnings (see ¶26.9) if you do not give the payer your taxpayer identification number.

Civil and criminal penalties can be imposed if you provide false information to avoid backup withholding.